

Memo

ANDERSEN

To The Files
From Dave Duncan
Deb Cash
Patty Grutzmacher
Jennifer Stevenson
Date March 28, 2000
Subject Raptor Transaction

Purpose

The creation of a vehicle used to hedge Enron's exposure related to equity investments (accounted for under either fair value or accrual accounting).

Transaction Structure

Under the transaction structure shown in the attached diagram (Exhibit I), Enron, Harrier LLC (Harrier), a wholly-owned subsidiary of Enron, and Talon LLC (Talon) executed a series of agreements that result in Harrier acquiring the right to execute equity swap transactions up to a notional amount of \$1 billion, or purchase put options through the conversion of a \$400 million note receivable from Talon LLC into option premiums. Talon is an SPE that is capitalized by LJMII, a third party equity holder, who serves as the managing equity holder of Talon, and Enron Corp. who has a preferred LP interest. LJMII is a related party entity (See LJMII memo in 4th quarter file for an explanation of the relationship).

In the structure, Talon receives the following from Harrier:

1. A \$50 million interest bearing note receivable, payable quarterly @ 7%;
2. 3,739,175 shares of Enron common stock which is restricted from sale for 3 years;
3. A contingent right to 3,876,755 of Enron common stock which could be delivered to Talon during 2003, subject to certain conditions being met (the "contingent forward") and which would be restricted from sale until 2005.;
4. A premium of \$41million for writing an Enron common stock share settled put option on 7,171,418 shares at a strike price of \$57.50/share, which expires 6 months from the closing date; and
5. A nominal net capital contribution of \$1,000 from Enron for its preferred LP interest.

The value of the Enron shares, given the restrictions, has been determined to be approximately \$350 million, as compared to the current value of a similar number of unrestricted Enron shares in the public market, which would be approximately \$536 million.

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Harrier receives the following from Talon:

1. A \$400 million note receivable that is convertible into option premiums, subject to Talon approval.
2. The ability to enter into derivatives, subject to Talon's approval, with a cumulative notional amount of \$1 billion;
3. A non-voting preferred limited liability company interest in Talon; and
4. A put option on Enron common stock whereby Enron has the obligation to deliver Enron shares to Talon for settlement below a stock price of \$57.50.

The obligations under this transaction will terminate upon the earliest occurrence of one of the following: (1) April 18, 2005, (2) the date either Talon or Harrier wish to terminate the agreement provided the proper notice is given, and (3) a default event, as defined in the various transaction documents. Termination of this agreement by one of the above circumstances only terminates Harrier's right and Talon's obligation to execute additional derivatives. Previously executed derivatives will remain in effect and do not automatically terminate without mutual consent of the parties.

Issues

1. Does the structure of Talon meet the minimum control requirements of a special purpose entity that supports non-consolidation by Enron? What are the initial and ongoing capitalization requirements of the SPE?
2. How should Enron account for its preferred limited liability company interest in Talon?
3. How should Enron account for the purchased share-settled put option?
4. What is the proper accounting for the contingent forward sales contract?
5. How will the value of the derivative transactions be substantiated?
6. What is the impact of Talon's credit worthiness on the value of the derivative instruments to Harrier?
7. What are the required disclosures in the Enron Corp. financial statements as a result of the transaction?

Issue 1

The sponsor of the Talon SPE is Harrier. As mentioned, the SPE was capitalized by an independent third party member, LJMI, who infused \$30 million of equity as its initial capital investment that will be at risk during the term of the structure. Harrier, who also made a \$1,000 capital investment, serves as the other member of the SPE. In analyzing whether non-consolidation is appropriate, specific control criteria must be met, and the initial and ongoing capital investment must be 3% of the total assets of the SPE.

Control Requirements

Based on Topic D-14, "Transactions Involving Special-Purpose Entities," the SEC staff believes that for non-consolidation recognition by the sponsor to be appropriate, the majority owner of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE and has substantive risks and rewards of ownership of the assets of the SPE.

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LJMII serves as the managing member of the SPE. Harrier has no involvement in the management or operations of the entity. Therefore the control requirements are met.

Capital Requirements

The typical capital requirement of an SPE is 3% residual equity at risk of the total assets of the entity in question. In considering this requirement as it relates to Talon, we considered the following:

1. The required equity capital was coming from LJMII, an investment partnership we knew to 1) include an Enron employee among its capital participants and 2) have debt in its overall capital structure. Accordingly, we needed to determine that the capital we were considering in our test was not attributable to the Enron employee (we had previously determined that we would not consider such capital as "qualifying" equity capital as it related to structured transactions with Enron) or borrowed capital (which does not qualify in any instance). We reviewed LJMII's balance sheet to confirm it had sufficient equity capital to finance its contribution to Talon exclusive of its debt capital and the Enron employee capital. We determined this to be the case and concluded that all of the LJMII contribution could be considered for purposes of the required capital test. We grossed-up the required capital amount to effectively discount the Enron employee's proportionate share of LJM II capital.

We discussed this issue with John Stewart of the Professional Standards Group who concurred with our conclusions.

2. As a part of the transaction origination, we noted that organizational expenses were being paid by Harrier directly to applicable third party vendors on behalf of Talon. Because these expenses are incurred by the SPE, but paid by Enron, we determined that they should be included in the 3% capital requirement analysis consistent with how we have seen this situation addressed in other SPE situations in practice.
3. It was contemplated that Talon would be entering into derivative transactions which might include swaps. Typically swaps done "at-the-money" have little to zero asset value at origination. We noted that using zero as the asset value for purposes of determining the minimum required amount of capital for these type instruments may not be reasonable, particularly as the instruments notional amount (maximum potential for loss) increased. We informed the company that we believed the minimum should be calculated on the notional amount (maximum potential for loss) of any such instruments and that we would follow that principle in applying the test.

We discussed this issue with John Stewart, Professional Standards Group, who concurred with our conclusions.

Although the option to redesignate earnings of the entity to capital at risk (see Redesignation memo dated March 28, 2000) is available, the terms of this transaction structure does not meet criteria 4;

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therefore, redesignation is not available. Therefore, as the maximum exposure of the entity changes (i.e. through leveraging Talon or increasing the notional capacity of derivatives), LJMII will be required to provide additional equity to capitalize the entity.

We discussed all the above matters in Issue 1 with Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 2

Harrier's preferred interest in Talon gives Enron the right to receive earnings from the entity that exceed certain earnings thresholds of the LJMII member as stated in the Talon Partnership Agreement. We noted that this interest is only settleable in cash (i.e., Enron cannot take any Enron shares Talon may hold in settlement). We considered whether it should be viewed as a derivative instrument. However, based on the form of the investment and the definition of a derivative as stated in SFAS 133, the form of the instrument is an investment and therefore should not be accounted for as a derivative.

Based on Topic D-46, a limited partnership investment should be accounted for using the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor. As indicated in the Issue 1 discussion, Harrier, Enron's wholly owned subsidiary, has an investment of less than 1% and no voting rights as a member. (See also memo dated December 31, 1999 regarding the powers of the Advisory Committee and LP's). Accordingly, we concluded that the investment should be accounted for under the cost method on the balance sheet of Enron Corp.

We also noted that the result of the structure could be that, through this investment or through its other transactions with Talon, Enron may generate a gain (or offset losses) with economic benefits from Talon that could include the effects of changes in value of its own stock. Important to our consideration of this potential was that 1) the stock was to be considered issued and outstanding and 2) Talon had effective ownership of the risk and rewards of the shares and 3) Enron had no rights to ultimate settlement of anything that may accrue to Enron in shares (Enron could only receive settlement in cash). We noted that, when evaluated as a whole, the structure had analogous characteristics to a derivative in Enron's own stock settleable only in cash. As the change in value of such derivatives is required to impact income, we concluded that this potential outcome as it related to Talon was acceptable.

We discussed this issue with Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 3

Enron purchased an option for \$41 million whereby Enron has the right to put 7,171,418 shares of Enron common stock to Talon at a strike price of \$57.50, the settlement of which is in the form of Enron shares.

The put option was executed at market and contains the normal termination provisions granted under an ISDA Swap Agreement. Based on EITF 96-13 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," contracts whose settlement is indexed to the company's own stock should follow specific accounting treatment based on the settlement method which could be share or cash settled. In March 2000, the EITF reached a consensus on EITF 00-7, "Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur" which states that contracts that may require a cash payment by the issuer upon the occurrence of future events outside the control of the issuer cannot be accounted for as equity. Because this purchased put option is indexed to Enron's stock and is settled only in shares at Enron's option, we determined that this contract should be accounted for as an equity instrument. Accordingly, the cost of the option should be accounted for through equity as opposed to income. This treatment is also appropriate for the value of any shares indicated to be deliverable under the terms of the instrument as it is evaluated on a current market basis at each reporting date. In addition, any shares so indicated should be included in the EPS calculation for such period, assuming they are dilutive.

We discussed the EPS issue with Ben Neuhausen of the Professional Standards Group who concurred with our conclusions.

Issue 4

The shares under the contingent forward sales contract between Harrier and Talon are currently issued and outstanding for purposes of calculating EPS for Enron Corp. Through this structure, Harrier has the obligation to deliver approximately 3.8 million of these shares if the value of each share equals or exceeds \$50.00. If the price of these shares is below \$50.00, Talon bears the risk. As a result, AA's view is that these shares should be included in the number of issued and outstanding shares.

We discussed this issue with Ben Neuhausen of the Professional Standards Group who concurred with our conclusions.

Issue 5

At the close of the transaction, no derivative instruments were executed other than Enron's purchased put option which was priced at market. However, until the termination of the entity, Harrier has the right to execute equity swap and option positions with Talon, subject to Talon's approval. Because it will be important to ensure that all transactions are priced at fair value, we informed the company that we will likely request an independent third party appraisal or a fairness opinion on the value if it is not readily confirmable by us using available public or other third party information.

Issue 6

As the derivative instruments are valued, assets or liabilities will be recognized on the books of Talon and Harrier since these instruments will be carried at fair value. Consistent with the valuation of all

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derivatives, the value recognized by each party will be subject to the capacity of the other party to financially fulfill the obligation (i.e. creditworthiness). As a result, the credit ability of the other party will be factored into the value of the derivative. Therefore, as Harrier records an asset based on the value of the derivatives, its value will represent Talon's ability to pay. Talon's credit capacity is represented by the fair value of Talon's net assets. This includes the fair value of the Enron stock at the date of valuation. As a result, AA will review each quarter of Enron's calculation supporting the value of derivative instruments relative to Talon's credit capacity.

We discussed this issue with John Stewart and Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 7

The managing member of Talon is an Enron related party and derivative transactions are executed between a wholly owned Enron subsidiary, Harrier, and Talon. As a result, certain disclosures are required. A description of the structure, its purpose and the related party nature of the parties involved should be reflected in the footnotes to the financial statements submitted in 10-Q and 10-K filings. We will review these filings to ensure all appropriate disclosure requirements are met.

Conclusion

We discussed the features of the structure with Mike Odom, Practice Director and Mike Lowther, concurring partner, who concurred with our conclusions.